UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF TENNESSEE
EASTERN DIVISION

IN RE:

KANDALA RAM CHARY,

Debtor.

BK #91-12120-WHB
Chapter 7

MERRILL LYNCH BUSINESS
FINANCIAL SERVICES, INC.,

Plaintiff,

v.

KANDALA RAM CHARY,

Defendant.

Adversary Proceeding
No. 92-0098

MEMORANDUM OPINION AND ORDER ON COMPLAINT TO
DETERMINE DISCHARGEABILITY OF DEBT

Merrill Lynch Business Financial Services, Inc. ("Merrill Lynch") filed its complaint to determine dischargeability of debt against Kandala Ram Chary ("Debtor or Chary") and the trial was conducted on January 22, 1993. Subsequent to the trial, Merrill Lynch moved to reopen the proof for the limited purpose of further examining Dr. Chary regarding his trial testimony that funds obtained on loan from Merrill Lynch were used for business purposes. A further hearing was held on that reopened proof on September 7, 1993, after which the Court took all matters under advisement. The Court has now considered the proof, including the testimony and exhibits, and the following contains findings of facts and conclusions of law pursuant to Federal Rule of Bankruptcy

Procedure 7052. This adversary proceeding raises core issues pursuant to 28 U.S.C. §157(b)(2)(I).

SUMMARY OF FACTS

The debtor was the sole shareholder and in control of Jackson Nephrology Clinic, P.C. ("JNC") in Jackson, Tennessee during 1988 and at all times pertinent to this adversary proceeding. Exhibit L. The debtor as the sole shareholder and primary officer of JNC had full control and discretion over the accounts and operations of JNC.

On or about March 7, 1988, Merrill Lynch, pursuant to a working capital management account agreement ("WCMA") with JNC issued a line of credit to JNC in the amount of $50,000.00. In connection with this account, JNC executed a promissory note. Exhibits A & B. The working capital management account agreement provided that JNC would "use the proceeds of the WCMA Loans primarily in connection with said business [as described in the WCMA application], and in any event, USE ALL PROCEEDS OF THE WCMA LOANS EXCLUSIVELY FOR BUSINESS PURPOSES, AND NOT FOR ANY PERSONAL, FAMILY OR HOUSEHOLD PURPOSE." Exhibit A, page 4.

On or about March 7, 1988, the debtor executed an individual guaranty of the WCMA debt of JNC to Merrill Lynch. Exhibit C.

The working capital management account could be accessed through use of checks, a funds transfer service, which allowed transfers to or from JNC's local bank, a federal funds wire transfer, and a Visa Card issued by another division of Merrill Lynch to JNC.

On or about February 7, 1990, Merrill Lynch extended JNC's line of credit to $100,000.00 with a maturity date of March 31, 1991. Exhibit F. Subsequently, the maturity date was temporarily extended until April 30, 1991. Exhibit G. In April, 1991, Merrill Lynch notified both JNC and the

debtor of the default in payment on the working capital management account and Merrill Lynch demanded full payment of the balance of $101,564.59. Exhibit H. Payment was not made by either JNC or the debtor.

Merrill Lynch filed suit against both JNC and the debtor on May 24, 1991, in the United States District Court for the Western District of Tennessee, and on July 5, 1991, Merrill Lynch obtained a judgment against the debtor in the amount of $138,141.69. Exhibit A to complaint. Subsequently, the debtor filed for Chapter 7 bankruptcy relief in this district. The debtor included the debt to Merrill Lynch on his bankruptcy schedules.

Merrill Lynch timely filed its proof of claim in this case based upon the district court judgment, and on January 21, 1992, Merrill Lynch filed its complaint to determine dischargeability of this debt.

In June, 1988, the account was first accessed by JNC and the debtor. There was proof that the debtor and JNC had accessed the credit line at numerous times, had paid some interest on the loan and had reduced the principal on the loan on occasion, subsequently drawing against the loan again. When the line of credit was increased, it was considered to be a performing loan by Merrill Lynch. For example, the June, 1990 statement indicates that JNC accessed the loan several times, often with checks payable to the debtor, with the amounts drawn ranging from $25,000.00 to $100,000.00. At the beginning of the June period, the account balance was $258.85 and at the end it was $100,336.38. Exhibit I. A representative of Merrill Lynch testified that the borrower could not exceed the $100,000.00 limit but that Merrill Lynch did not monitor on a day to day basis the purpose for which loan proceeds were drawn. When the Visa card would be used by the borrower to access this account another division of Merrill Lynch handled those Visa transactions and the

Chicago office of Merrill Lynch, which was in charge of this account, did not see the actual Visa receipts. The representative testified that notwithstanding JNC reaching its credit limit twice in June, 1990, the account was not investigated until default occurred. In March, 1991, the account was noticed by Merrill Lynch as being a potential problem account, whereas in 1990 the account was in good standing.

Upon default and after investigation by Merrill Lynch, it was first discovered by the witness testifying on behalf of Merrill Lynch that the account had been used in Atlantic City and other locations for gambling purposes. In June and July of 1988 cash was withdrawn by Visa in Nassau and in Trump Plaza, Atlantic City. Exhibit J. This pattern continued in later months of 1988, 1989 and 1990, including Visa usage in Las Vegas. Id. Checks were drawn on numerous occasions that were payable to Dr. Chary personally. The monthly statements used in Merrill Lynch's investigation were submitted as Exhibits I and J.

The debtor, Dr. Chary, testified that he had drawn funds from this account on numerous occasions but that he could not recall the actual purpose of all of the withdrawals. He testified that he did not believe that the account had been used for non-business purposes for June through August, 1990. However, he could only testify specifically as to one check payable to him from the account which was used to pay on a note at First American Bank in Jackson. This was a note on which the Jackson Athletic Club was the principal obligor but the Jackson Nephrology Clinic was an obligor. Dr. Chary admitted that he had previously used the Merrill Lynch account for gambling purposes but that those gambling debts had been repaid. The debtor testified that he did not have any personal records to support his usage of the account, as all of his records were in the hands of the United States Attorney. When asked about two checks in July and August, 1990, each payable in

the amount of $50,000.00 to him from this account, he again testified that these were used to pay on the First American National Bank note for the Athletic Club debt and that he could not recall whether those two checks were deposited in the JNC account first. After being shown Exhibit K, demonstrating that the checks were not deposited into the JNC account at First American National Bank, Dr. Chary testified that the two $50,000.00 checks were deposited into his personal account but that he did not use those proceeds for any non-business purpose. In the reopened proof, the debtor was recalled and testified again that the Merrill Lynch account was used on occasion to pay debts of the Jackson Athletic Club. He testified that the funds from the Merrill Lynch account mostly went first into his personal account and then were used to pay First American National Bank on the Jackson Athletic Club debt. In Exhibit J there is one check drawn on the account on June 28, 1990 for $50,000.00 payable jointly to Dr. Chary and First American Bank. The debtor also testified that there was a great deal of litigation against him and confusion as he was using the Merrill Lynch account and he was unable to keep up with all matters. The debtor testified that he kept Merrill Lynch advised of his use of the account. There was no admissible proof that Merrill Lynch actually knew that the account had been used for non-business, including gambling, purposes at any time, although there arguably may be constructive notice.

For the time applicable before the closing of this account, it appears that the draws were by checks payable to Dr. Chary or to Dr. Chary and First American National Bank. There is no proof that any of the last account usages were for gambling purposes or were payable at known gambling locations.

DISCUSSION

The complaint alleges either a violation of 11 U.S.C. §523(a)(2) or (a)(4). From the proof, it can only be that Merrill Lynch is relying upon §523(a)(2)(A), as part (B) of that Code section relates to false written financial statements. There is no proof that Merrill Lynch relied upon a written financial statement from Dr. Chary, the debtor. To prevail under §523(a)(2)(A) the creditor must prove the statutory elements of false pretenses, a false representation, or actual fraud. Moreover, in this Circuit, the creditor must have reasonably relied upon the debtor's act or statement. In re Phillips, 804 F. 2d 930 (6th Cir. 1986); In re Ledford, 970 F. 2d 1556 (6th Cir. 1992), cert. den. _____ U.S. _____, 113 S. C t. 1272 (1993) (retaining non-rigorous reasonable reliance standard as a factual issue). It is the debtor's position that the proof at best shows that JNC breached its loan covenant not to utilize loan proceeds for any non-business purpose. However, that argument, while valid, fails to address the liability for actual false pretenses, false representations or actual fraud that may fall upon the debtor as the sole shareholder and principal officer of JNC and as the one who made decisions for JNC. The proof clearly establishes that Dr. Chary was in control of this account, often writing checks on the account payable to himself and depositing those funds into his personal account before their ultimate use. The issue ultimately in this case is whether the debtor, as the controlling individual behind JNC and as a guarantor on this obligation, knowingly used the loan funds for non-business purposes and whether that misuse constituted a misrepresentation to Merrill Lynch. As the Seventh Circuit has indicated, when the debtor has no apparent intention of using the money for its specified purpose, misrepresentation may exist. See In re Pappas, 661 F. 2d 82 (7th Cir. 1981). The proof here does show that JNC and the debtor accessed the account on many occasions and repaid the loan so as to continue the line of credit in good standing and to permit

continued use of the account. The debtor's good intentions can certainly be argued based upon JNC's and the debtor's pattern of repayment of the account before it fell into default.

The critical inquiry here is whether the debtor used false representations, false pretenses or fraudulent actions to induce Merrill Lynch to make the loan advances from June, 1990 forward, after the account had been paid down to a $258.85 balance as of May 31, 1990. The debtor's prior uses of the account for personal, gambling or other non-business purposes prior to June, 1990 are irrelevant to the issue before the Court as the account had been repaid. Merrill Lynch can only complain about its actual losses, not its potential losses if the debtor had not repaid the gambling loans.

However, the account was clearly intended for business purposes, and the agreement so specified. Exhibit A, page 4. The debtor argues that Merrill Lynch was aware or should have been aware that he had on occasion used the account for gambling purposes. The debtor of course testified that he had repaid any gambling usage from this account prior to the account becoming delinquent. The Court assumes that the debtor's argument is that Merrill Lynch could not have reasonably relied upon any representations of the debtor in so using the account as Merrill Lynch would have been put on actual or constructive notice. However, the Court has concluded that there is no proof that the account was used for gambling purposes after June 1, 1990. Nor is there proof of how the loans were used after that date other than Dr. Chary's testimony that the funds were used for business purposes.

This was not the debtor's account. This was an account established by Merrill Lynch in the name of Jackson Nephrology Clinic, P.C., with the debtor as a guarantor. The collateral on the account was a first lien on accounts receivable of JNC. Exhibit D. The Court has been able to find nothing in the account paperwork that would indicate that the debtor could personally use this

account for personal purposes or for business purposes other than for the Jackson Nephrology Clinic. Here there is proof that JNC was a co-obligor on the First National Bank debt for which Dr. Chary testified the Merrill Lynch account was drawn.

The Court is aware that the objecting creditor has the burden of proof to show that the debt is excepted from discharge by a preponderance of the evidence. See Grogan v. Garner, 498 U.S. 279, 111 S. Ct. 654, 112 L. Ed. 2d 755 (1991). Although the debtor has provided only a bare explanation of his use of this account, he has testified that the account was used for business purposes in June, July and August 1990. These are the months in which Merrill Lynch suffered its loss for nonpayment by either JNC or Dr. Chary. While bare, the debtor's explanation was credible. The debtor was candid with the Court about prior improper use of the account for gambling, which use was repaid in full.

In summary, the Court has concluded that Merrill Lynch has by a preponderance of the evidence shown that the debtor, as the controlling officer of JNC, had access to this working capital management account and that he personally accessed the account for both business and non-business purposes during the account's life. However, Merrill Lynch has failed to prove that the account was used for non-business purposes for that specific period after June 1, 1990, when Merrill Lynch suffered its loss. Thus, the Court makes a factual finding that Merrill Lynch failed in its burden of proof to show that Dr. Chary obtained the funds, which were not repaid to Merrill Lynch, on the basis of his false representations, false pretenses, or actual fraud. Failure of this proof obviates the necessity to discuss Merrill Lynch's reasonable reliance.

As to §523(a)(4), there is no factual proof of embezzlement or larceny. Nor was there proof of an express or statutory fiduciary relationship between Dr. Chary and Merrill Lynch. Thus, the proof fails to provide a basis for relief under 11 U.S.C. §523(a)(4).

As such, the judgment entered in favor of Merrill Lynch and against the debtor in the United States District Court is not excepted from discharge under 11 U.S.C. §523(a)(2)(A) or §523(a)(4). Judgment will be given in favor of the debtor's receiving a discharge of this debt.

The above is so **ORDERED** this 12th day of October, 1993, and a separate judgment will be entered.

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WILLIAM HOUSTON BROWN
UNITED STATES BANKRUPTCY JUDGE

cc:

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